DOW THEORY LETTERS INC.

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Aug. 17, DJIA 871.84; PTI 641; A-D ratio -15.98
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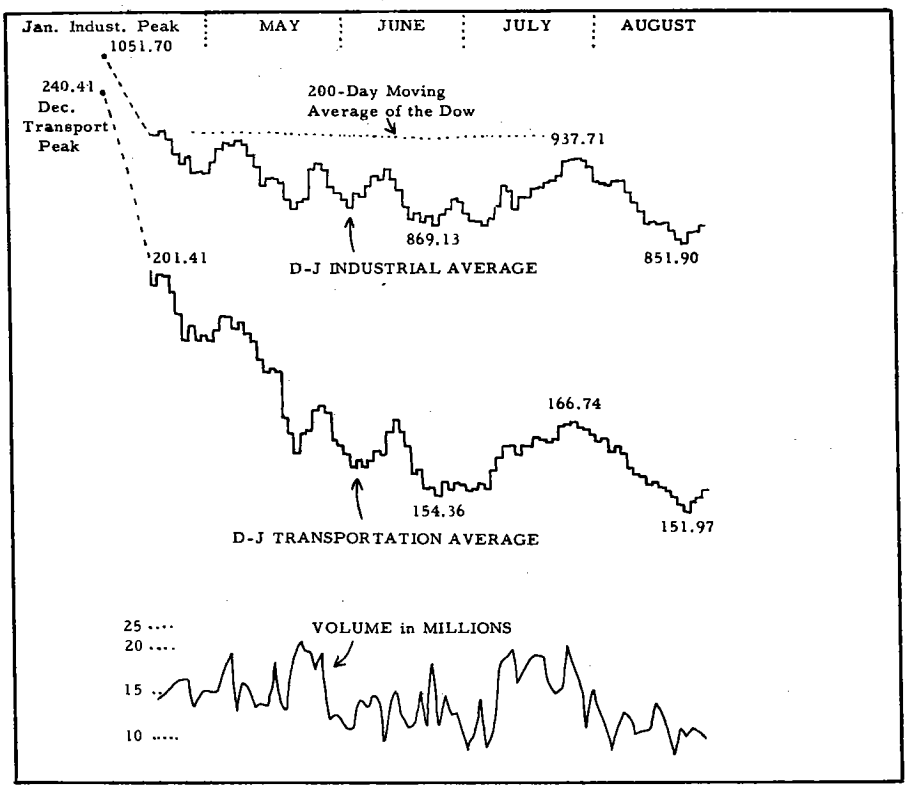
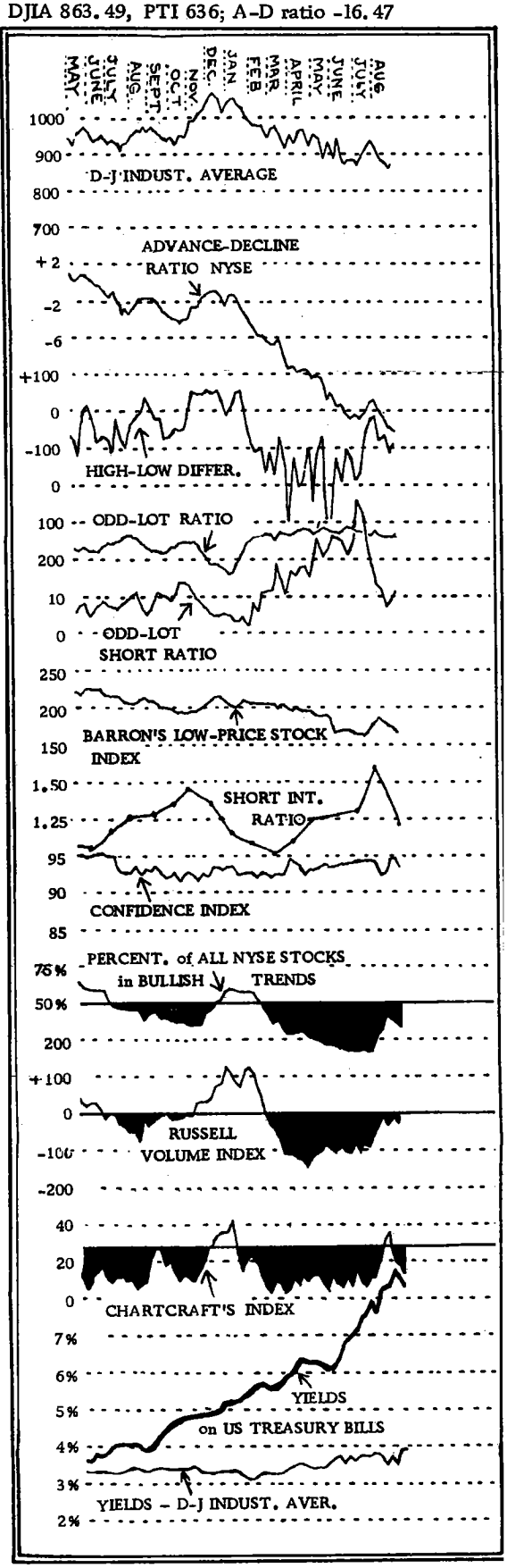
THE PICTURE: Long term trends, primary movements, the sweep of history, all these interest few people on Wall Street. Stockholders are more interested in the news items of the day, where the market is "at noon," and "What President Nixon said last night." Over the past few weeks the nation received a package of long-awaited "good news." (1) International money rates may have topped out. (2) Commodity prices broke. (3) Utilities and bonds rallied. (4) The price of gold bullion dipped below $100 for the first time in months. (5) The US balance-of-payments looked a good deal better.

Following a crushing and persistent decline from the July 27 peak, the market on August 23 turned up and advanced throughout the session. Personally, I always hesitate to pontificate on what the latest rally "means." What I do is watch the various gauges of market action, and I try to ascertain whether we are getting a picture of real strength, and if so, whether the strength compares favorably with the last area of strength, and whether there are any serious discrepancies in the picture.

Currently, all Wall Street technicians can be divided into two camps. The first, those who are of the opinion that the "real bottom" has, to all intents and purposes, already been established by the market. They argue that new lows peaked back in May with the weekly plurality of lows over highs hitting minus 935 on the week ending May 25. Many of the unweighted Averages touched their lows in early July. Other important Averages such as the NYSE Composite recorded their lows on July 6. The period of greatest weakness has passed, argue the optimists. What we are seeing now is base building and a shaking out of the weak hands. The next major move will be up.

The bearish faction notes that both the Dow Industrials and Transports touched new 1973 lows last week (August 22). On the same day the D-J Utilities sank to their



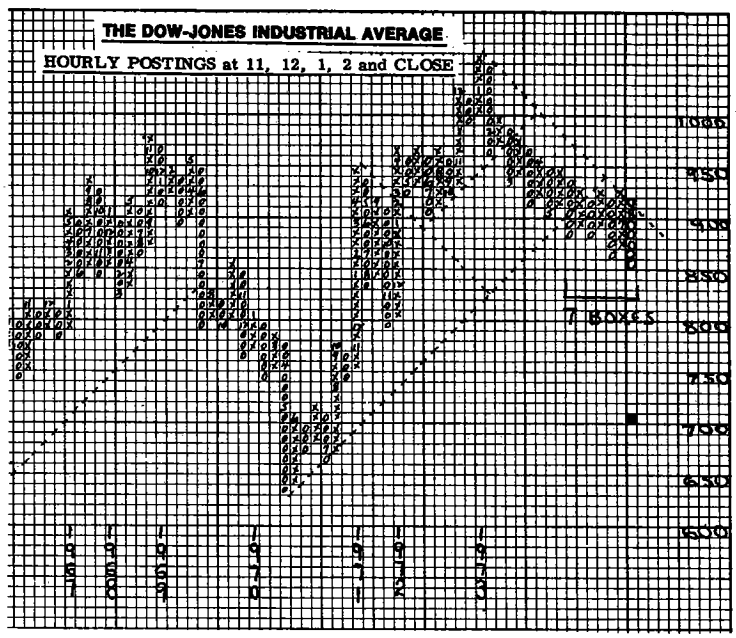


exact previous low of 94.55. Had Utilities dropped the smallest fraction lower, all three Dow Averages would have been at new lows for the first time since 1970. Worth noting also is the fact that the broad S & P 500 Average and the S & P 425 Industrial Average recorded 1973 lows on August 22. The doubter also observes that on the week ending August 24, 13 of the 30 Dow Industrials touched new 1973 lows, indicating that the Dow weakness is spreading. Further, they note that new lows (daily or weekly) have remained persistently high, while new highs have been few and far between.

As far as I personally am concerned, I see my Primary Trend Index (PTI) sinking steadily, its last low being recorded on August 22. That low was confirmed by a fresh new low on the A-D ratio. The Cumulative Most-Active Stock Index (CMAS) has been breaking to new lows all along, while the oscillating Most-Active Stock Index (MAS) holds firmly below zero. "Will Go" calls for market weakness through the end of October, with the first rally "scheduled" for the week ending November 2. As previously mentioned, the D-J Industrials and Transports touched new lows together on August 22, following which the market rallied. But the majority of important bottoms are not established on joint new lows. Rather, they come from downside non-confirmation, with one Average breaking to a new low, unconfirmed by the other.

Thus what I see this year is a continuous series of eroding new lows, sharp rallies, then further new lows. From a Dow Theory standpoint, the primary and secondary trends continue down. I might also warn that in a primary bear market (particularly during a second phase, such as the one we are now in) the action can be most deceptive. The downward action can be halting, sporadic, "tired-looking." It can be punctuated with many "hopeful little signs." Yet the bear has a disconcerting habit of getting his own way, washing out the pretty little signs, destroying the "new optimists," as the market moves towards its ultimate destiny on the downside. This is what I see happening here in 1973.

I am including a Point & Figure chart of the Dow Industrials with this issue (chart courtesy of Chartcraft, Larchmont, NY 09538). This is a very concentrated P & F chart, with each box representing a full 10 points, and only reversals (i.e., rallies and declines) of a full 30 points or more depicted. Vertical rows of X's indicate rallies of 30 points or more, while vertical rows of O's denote declines of at least 30 points. The chart shows all the major swings (30 points or more) since late 1966.

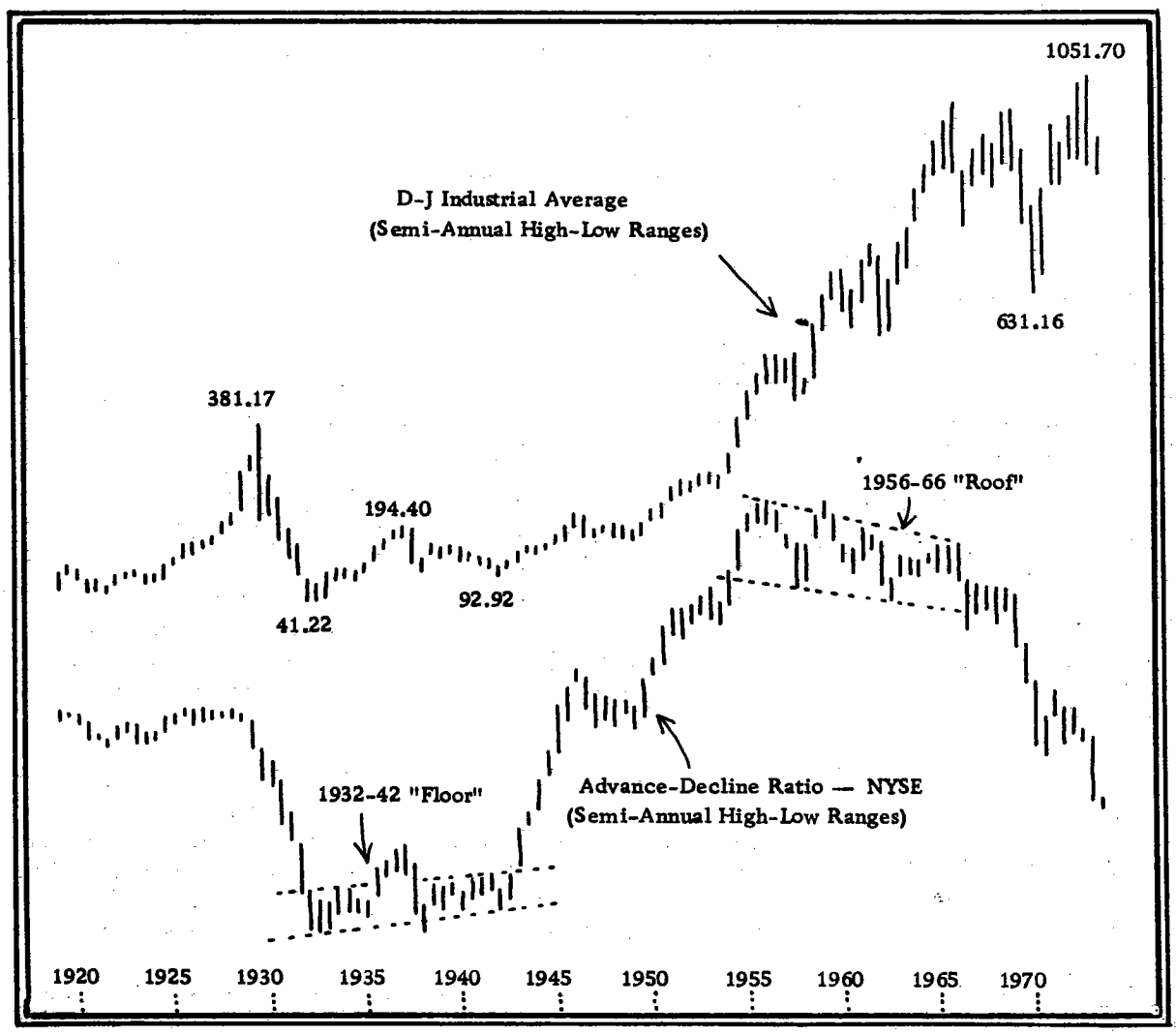


One of the great advantages of P & F work is that in compressing the action, it also presents patterns which may not be clear on more detailed (daily, weekly or even monthly) charts. For instance, note that all the action from 1971 to date appears on this chart as a giant "head-and-shoulders" top in the Dow. The first area of distribution occurred in the 900-950 area of 1971-72. The run-up to the all-time high of 1051.70 in January, 1973, formed the "head" in the pattern. The area of 890-935 which was explored during most of 1973 constitutes the right shoulder.

As the formation now stands, the implication is that steady distribution has been going on for three years, and most persistently since the 1973 peak. Note that three bottoms were formed at the 890 level, during 1973, and this "triple bottom" was penetrated on the downside in June. This was followed by the July rally which took the Dow to the 930 box (at which point the Dow's progress was halted by the descending trendline).

Most recently, the Dow plunged to the 860 box (last vertical row of O's). Interestingly, the hourly low was recorded by the Dow at 850.02 at 11 AM on August 22. Had that reading been 850.00 even, the last row of O's would have declined to the 850 level on the chart. But the 10-point P & F chart demands a full 10 points for each entry, not 9.98 points. Thus, although the Dow declined to 850.02, the chart shows the decline to only 860. (Note that any rally would now meet the descending trendline at the 910 level).

I often mention the "count" or objective on P & F charts. These are, of course, merely technical possibilities. In primary bull markets, upside counts are often met or surpassed, and the downside objectives are often met or surpassed during bear markets. The most conservative count I can take now is a horizontal count on the most recent "area of congestion." This is the 7 boxes as shown on the chart. Multiplying the 7-box width of this formation by 30 (this is a 30-point reversal chart), I get a figure of 210. Subtracting 210 from the peak of the formation at 930 gives me a first objective of 710 (shown by the solid black box). The 710 level then, is our first downside target based on P & F.



BREADTH (A-D RATIO): I have been asked, "Russell, if you were allowed only one indicator besides the market averages to watch, what would you pick?" Without hesitation, I always answer, "The advance-decline ratio." I learned about the A-D ratio from James Hughes, who was then working on Wall Street for the old brokerage firm of Auchincloss, Parker, Redpath. Hughes, along with Colonel Ayres of the Cleveland Trust Co., had invented the A-D ratio. I used to read Hughes' A-D ratio studies of the 1950's like an archeologist who had discovered the key to a lost civilization. If I didn't understand something, I would call Hughes on the phone (he was a feisty gentleman, and he was usually put out if I didn't comprehend one of his "simple points"). Few analysts today understand 20% of what Hughes uncovered in his remarkable and detailed breadth studies. Hughes' work was a revelation to me.

Back in Letter 531 (June 7, 1972) I called attention to the "ominous breadth performance," and I presented a comparison of the 1971-72 breadth picture with that of 1965-66. I concluded that "the breadth-price relationship of 1971-72 is as poor as I have ever seen it." At that time few Wall Streeters were anything but bullish on the prospect for the stock market, and literally no one was taking the horrendous breadth-price divergence seriously.

Then in Letter 541 (September 20, 1972) I presented my very long-term A-D ratio chart, a chart plotted semi-annually (six-month high-low ranges) showing the Dow and the A-D ratio going back to 1919. In Letter 541 I again pointed to the bearishness of the breadth picture. I noted that the A-D ratio was just beginning to fall out of a triangle (see chart), and I opined that "...the possibility is there for another wide-open smash on the order of 1969-70." A few months later the Dow ran up deceptively to its all-time high of 1051.70, and my A-D ratio studies were ignored (except, I am happy to say, by my subscribers). From then on (following the non-confirmed new high in the Dow) it was a case of collapse and shambles for the market. A divergent relationship between the Dow and the A-D ratio had again called the turn.

I am publishing the semi-annual chart (page 3) of the A-D ratio for the third time with this mailing. We can immediately see that the January to July breakdown from the 1970-72 triangle is one of the worst and costliest on record. It is also interesting to note that as far as breadth is concerned, 1970 to 1972, far from being a mini-bull market, was just a period of distribution preparatory to the 1973 spill, a spill which is still going on at this time. The final little vertical bar on the A-D ratio represents the action for the second half of 1973 or for the period of July 1 to date. How far this will carry before 1973 is over no one can tell at this time. My guess is that it will be considerable.

I want to draw attention to another phenomenon which I see on this chart. Note that the period from 1932 to 1942 (10 years) constituted a massive up-slanting base or platform from which the incredible breadth rise of 1943 to 1956 was mounted. This was the greatest A-D ratio climb in history, and between 1942 and 1956 almost everything that wasn't nailed down moved higher. Nothing like the profit-making opportunities of 1942-56 have been seen on Wall Street since (although there have been many selective and explosive bull movements).

So we see the base of 1932-42 and the great and incredibly broad bull market of 1943-56. From 1956 to 1966 I believe the market was forming a giant distributive roof on the A-D ratio, a down-slanting roof which was the exact opposite of the 1932-42 base. Just as the majority of issues were being accumulated during 1932-42, the majority of issues were being distributed during 1956-66 (is it a coincidence that both periods lasted exactly 10 years?).

Since 1966, it is my opinion (I believe only E. George Schaefer of Indianapolis shares this view with me) that we have been in a primary bear market of spectacular proportions. Now each bear market is different; each one has its own particular characteristics (characteristics which are not usually understood at the time). I feel that the outstanding phenomenon of this bear market is that it has succeeded in smashing the majority of issues while still retaining so much "hope" on Wall Street. How was this done? By allowing the Averages (particularly the Dow) to "stay up" while the majority of issues on all the exchanges, were being pulverized. And that process has really shown up on the A-D ratio. But unfortunately, almost no one has kept a record of the long-term path of breadth (in fact, no other service has carried anything like the accompanying half-century chart of breadth).

As I see it, we are now in our second huge descending wave down (1969-70 was the first) from the 1956-66 roof of distribution in the A-D ratio. It is very possible that when this movement is over, the bear market will have breathed its last. How long will this descent last and how many more points on the downside will it require? Here I must plead ignorance. I can offer my own guesses, but I would rather present my observations and conclusions as we go along. As my friend Garfield Drew is fond of saying, it is easier to identify than to guess. When the ultimate bottom comes, I hope to be one of those intrepid souls who says, "Here, this is it, we've arrived" (undoubtedly to the hoots and derision of those who are still left on Wall Street).

BUILT-IN INFLATION? Two and two equal four; it always will. The current rate of Government spending and the current rate of debt formation equals ultimate destruction of the dollar. It's as simple and ominous as that. As the dollar moves towards destruction, men will turn increasingly towards the single time-honored "store of value" vehicle — gold. If anyone can punch a hole in the foregoing set of assumptions and conclusions, please let me know.

In a much discussed recent report, Wesley Hillendahl, Director of Research at the Bank of Hawaii notes that during the Great Depression Government spending rose to around 20-23% of personal income. During World War II the figure rose temporarily to 62%, and this resulted in a period of fantastic inflation. By 1947 the spending figure had dropped back to 23%. But by 1960 the Government spending percentage had risen to 36% and by 1970 it had boomed to 43.5%.

The current 43.5% rate is twice the rate of twenty years ago. A study of the entire time span indicates that the maximum Government spending to personal income percentage which can exist without promoting inflation is in the 20-25% range. Hillendahl shows how, during World War II, when the ratio jumped to 63%, the money supply also exploded, doubling between 1941 and 1946!

At today's 43.5% spending ratio, the money supply must boom just to "keep the Government in business." In other words, built-in Government spending is now so huge that inflation is a continuing necessity just to pay the Government's yearly bills. Hillendahl has projected his figures, and he states that by 1980 a regular 15% increase in the money supply will be needed to sustain the nation. By 1985 an annual 20% money supply increase will be needed.

Thus the writing is on the wall. The US Government has turned into a monster of insatiable spending. US consumers have taken their cue from the Government and are also spending at an enormous rate. In the face of this continuing all around spending orgy, the value of the dollar (against real value — gold) is guaranteed to decline.

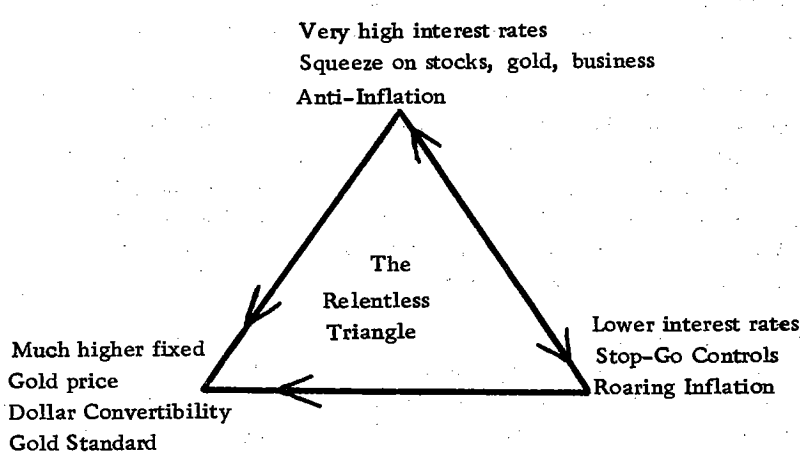
On August 16 a curious event took place. On that day the price of gold in London jumped $9, but curiously the dollar was termed "strong" by the various wire services. Now what they meant was that the dollar was strong against other paper currencies. The fact is, of course, that the dollar was weak against real value or gold, but other currencies were even weaker.

In other words, up to now we have been used to see-saw action in which the dollar rose and gold declined, or the dollar declined while gold rallied. But looming on the horizon is the picture which Bill Tehan (Letter 571, page 5) foresaw. It is the situation in which the dollar embarks on a technical rally (now occurring) while all other currencies (which are now overvalued against the dollar) turn weak. States Tehan in a late report, "This shift of capital movement in foreign exchange markets (i.e., the shift to strength in the dollar and weakness in other currencies) is one of the most bearish developments in modern monetary history and brings the monetary crisis into the beginning of a massive deflationary phase."

In other words, for about three years various strong foreign currencies were widely used as "store of value" vehicles. These currencies are now turning weak against the dollar. As weakness continues in these currencies and as huge losses build up for holders of these currencies, it will be seen that the only real store of value is gold. This realization could mark the beginning of a dramatic scramble for the yellow metal. If interest rates are also declining during such a period, the scramble for gold would be intensified.

Rumors are now flying regarding the late-September meeting of the IMF in Nairobi. Some say that a new "official price" will be set for gold. This could occur, but I somehow doubt it. At any rate, if an official price is set and it is to stick, it will have to be high enough (above the free market price) so that all holders of gold shares and gold bullion will say, "Here, take my stock and my bullion, I'm satisfied that there is no further point in speculating for a higher gold price. The fair price for gold has arrived, and as far as I am concerned, my hedging and speculative needs are over."

THE TRIANGLE: I have been wracking my brains for a way to show subscribers what I believe is going on. At 4 AM Saturday, August 11, I woke up with the words "Relentless Triangle" going through my head. I immediately got up and drew the triangle which is shown on this page. I have always believed that a "single picture is worth a thousand words," and I am always pleased if I can get a problem down in visual terms. At any rate, this is the problem which is now confronting the nation (and the world). Note on the triangle that I have drawn the arrows on the right side going back and forth or from inflation (lower interest rates) to anti-inflation (higher interest rates). But ultimately both points gravitate towards the left point which entails a much higher fixed price for gold, dollar convertibility, stability in that the world would turn to a gold standard and gold settlements, rather than demonetizing the debt and manufacturing paper money.



Those who are perplexed, confused or frightened at the current seemingly "insane" turn of events in the US and world economy should study this chart carefully. The choices (simplified, of course) are presented here, and there is no way out until the choice at the left is chosen or forced upon the world. But ultimately this is the decision which will have its way. For when men act weakly and money becomes suspect the power of gold takes increasing command of the situation. It has happened this way for thousands of years.

THOUGHTS & NOTES: In my 15 years as writer of these reports, I have never seen a time when so many people were going "nuts." For the first time in all those years, subscriptions are coming in without a word about stocks, bonds, investments. People simply want to know what the devil is going on. They are confused, scared, cynical; they don't know which way to turn. And I'm not talking about just the subscriber with the shoe store in Des Moines or the real estate business in Miami, I'm also talking about heads of corporations, heads of giant divisions, men who are leaders in business. The "feeling" is the same all over — "What's happening, what can we believe, which way do we turn?"

I'll take this opportunity to say again that I cannot answer personal letters. Sometimes, I do try, but I get swamped. It wears me out. There are too many of them. Subscriptions are running ahead of last year and every other one has a question. I try to answer them if I can. But it takes a tremendous amount of energy.

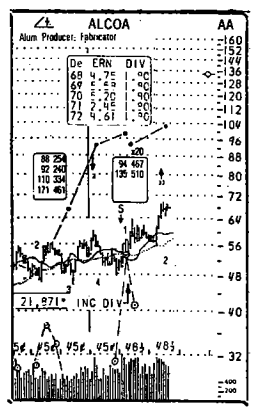
My friend Eliot Janeway stated in his most recent "Janeway Letter" that Wall Street member firms "are emerging as a more authoritative leading indicator than any of the popular statistical services." I believe he's right, and if he is we're in for some severe shocks ahead, because Wall Street is not in good shape now. In a phrase, the liquidity of some of the firms is in question.

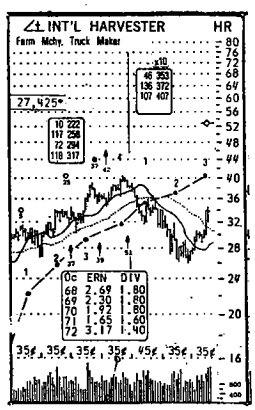
Meanwhile, the Fed is unable to control the money supply, and the commerical banks are paying whatever they have to pay to get Certificate of Deposit money. The C/D's are creating money which the Fed cannot control, and so my latest St. Louis Federal Reserve Board chart of the money supply looks inflationary and the money supply line appears to be about to break to another all-time high.

Just as Janeway senses new leading indicators of the business-market condition, I too, often sense an index which I feel should be accorded great authority. Right now I would say it is world stock exchange averages (see last Letter). The leading stock markets of the world are now heading down in earnest (statistics in Barron's each week), and this has an ominous ring to it. Does it mean that as the US dollar rallies, the economies of the rest of the world decline? I suspect it does. If the dollar gets strong here, it means that other currencies are staggering. When that happens, Europe tends to fight the slide with high interest rates, and the business community feels the noose around its neck tightening. A business slump in Europe would be a very serious thing at this time. But it would intensify the pressure from Europe for a stable monetary system.

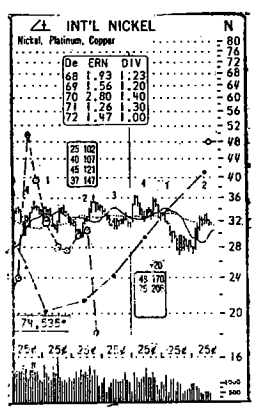
During the first week in September, the Arab world meets to try to get together on their oil policy. It is becoming more obvious daily that oil is going to be the lever the Arabs use as they try to force Israel to its knees. This situation should supply enough food for worry for even the most seasoned pessimist. Were the powers above playing a joke when they gave us our first Jewish Secretary of State? (I'm allowed to comment on that, being of the same religion as Mr. Kissinger).

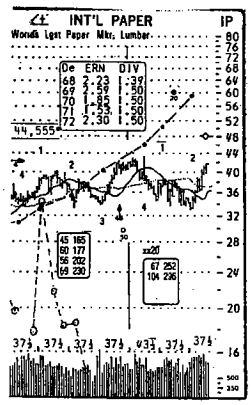
STOCKS: Older readers know that I always pay alot of attention to the technical position of the 30 Dow Industrials, not only because they represent a huge chunk of the value of the NYSE but because they so often lead the market (or at least they tend to provide good indications of investor thinking).





At present, the strongest reading (4 out of 6) goes to International Paper with the number two spots being shared by Alcoa (3), International Harvester (3) and International Nickel (3). Twenty Dow stocks have readings of zero or one, which means that one-third of the 30 Industrials are providing the technical strength. I am including weekly charts (courtesy of Quote Digest, PO Box 213, Wichita, KS 67201) so that readers may see the stalwarts in the nation's most widely-followed stock Average.





Following are some comments on Dow stocks based on my long-term point & figure charts. Allied Chemical: strong base, one of the better looking patterns, a breakout in the 37 area would be bullish. American Brands: amazingly weak, major breakdown at 36. American Can: this one has got to be tired of going down. Would have to go to a new low at 26 for a fresh bearish reading. Telephone: breakdown occurred at 49, but not too bad. Chrysler: major top-out along with GM. Relative strength in the Auto group kaput. DuPont: important top here. Should end up much lower, out of a Head-and-shoulder pattern. Exxon: all three Dow oils (Stand. of Cal., Texaco) have had it, and I don't think the reasons for the bad action are known yet. Gen. Food: like Am. Can, this one has to be tired of going down — but it's still bearish. Johns Manville and Owens Illinois: both horrendous crashes, but could make up alot on a technical recovery. Proctor and Gamble: finally topped out and penetrated its long, ascending trendline. Any rally here is a chance to get out. US Steel: don't think it's going to break its '71 low of 25 in a hurry, but it can't seem to get started on the upside either. There was a time when they said, "As Steel goes, so goes the market." Remember that? Woolworth: in the "can't get any lower category." But I said that six months ago. At 25 we'd have an upside breakout here.

FINAL THOUGHT: I have received many letters from subscribers saying that they like to hear my thoughts or as Bob Gross of Professional Investor puts it, my West Coast flower-child philosophy (c'mon Bob, don't be mean). At any rate, every once in a while I stop and think, "Suppose the monetary system does collapse? Suppose the US comes out with red and brown and purple tissue-paper dollars, and we all have to turn in what's left of the old green ones? Then where would we be, where would all our savings, planning, scheming, have gotten us? We'd all have to start rethinking our lives, wouldn't we? Yeah, I tell myself, so why wait, why wait?" Of course, if your money's gotten you everything you want in life already, then just ignore this paragraph.